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IMF Concludes Article IV Consultation with France

The IMF Executive Board on October 22, 1997 concluded the 1997 Article IV consultation[1] with France.

Background

Economic activity has been sluggish over the last two years; and in 1996, the third year of the recovery from the last recession, real GDP increased by only 1.5 percent. With high unemployment, fiscal withdrawal, and weak household confidence, the contribution of private consumption was relatively limited. Investment has been weak and destocking has continued. Even so, there was a modest acceleration of activity between the first and second halves of last year; and in early 1997 indicators pointed to a continuation of this pickup. Adjusted for working-day variations, real GDP rose at an annual rate of 2¼ percent during the first half of this year.

By mid-1997, ***unemployment*** had reached 12.6 percent, exceeding the record level of 1994. Though cyclical factors played a significant part in its recent rise, some three-quarters of unemployment appears to be structural in nature. ***Inflation*** remained low, with the 12-month increase in the CPI at about 1 percent in recent months. The ***current account*** surplus widened to 1¼ percent of GDP in 1996; the offset was largely in sizable portfolio outflows, as firms allocated a high portion of their liquid assets to foreign securities, and non-residents made net sales of French bonds. So far in 1997, the current account surplus has continued to rise, largely reflecting increasingly firm export growth.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepare a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

Fiscal consolidation since 1995 has been significant. The general government deficit was cut by 1½ percent of GDP over 1995-96 and will decline by a further ½ percent of GDP this year (excluding special factors). It has, however, relied heavily on tax increases which pushed the already high public revenue burden beyond 50 percent of GDP.

In 1997, with a view to reducing the overall fiscal deficit to 3.0 percent of GDP, the state budget featured a stronger emphasis on expenditure control: the goal was unchanged nominal spending—entailing sharp cuts in investment, and housing and employment programs, and a wage rise of less than 1 percent. Meanwhile, the personal income tax was cut by close to 0.3 percent of GDP. The social security deficit was to be reduced by a blend of spending and revenue measures. In the event, the pattern of cyclical activity gave rise to expectations of a substantial shortfall in tax receipts (primarily VAT), and revenue projections were revised down by ¼ percent of GDP. Against this background, the new government decided to hold expenditure to the level envisaged in the initial budget (after some restructuring to reflect changed priorities); and it increased corporate taxes by an amount equivalent to 0.3 percent of GDP. Staff projections suggest that with these measures in place, the general government deficit is likely to be 3.1 percent of GDP in 1997.

The 1998 draft state budget envisages some further tax measures, equivalent to about 0.15 percent of GDP, and a freeze on real expenditure. The government also announced new steps to bring the finances of the social security system into balance by 1999, through a combination of revenue measures and expenditure restraint. The revenue measures include a reduction in wage based health insurance contributions, which is more than offset by a higher flat rate tax on personal income. Staff projections suggest that these policies will be sufficient to hold the general government deficit to 3.0 percent of GDP in 1998.

Monetary policy in 1996-97 has continued to be geared strictly to the deutsche mark link and the goal of low inflation. The increased credibility of French monetary policy—which has been pursued firmly for more than a decade—as well as significant fiscal consolidation have over the past year-and-a-half stilled the market turbulence seen in 1993 and 1995; and, with confidence in EMU resilient, interest rates in France are now among the lowest in the world. Together with the marked appreciation of the Italian lira, the U.S. dollar and the pound sterling, these developments have contributed to a substantial easing of monetary conditions, which should continue to spur the recovery. The 20 basis point increase in the intervention rate in early October is not expected to have a material effect on the economic outlook.

Recent ***labor market measures*** have included a 4 percent increase in the minimum wage, the initiation of an employment program to create 700,000 new jobs over several years (of which half in the public sector), and some additional tax exemptions for new hiring. In connection with the labor market conference held in early October, the authorities also decided to cut the legal working week from presently 39 hours to 35 by 2000 (2002 for small firms); provide subsidies during 1998-99 for employers who reduce the length of the workweek by at least 10 percent and increase employment by 6 percent; further liberalize early retirement; and change overtime and part-time work regulations.

The latest staff ***projections*** envisage an acceleration of economic activity in the second half of 1997, which would result in a growth rate of 2.3 percent for the year as a whole. In 1998, the economy is expected to firm further, with year-average growth of 2.8 percent. Moderate wage growth, reflecting inter alia an unemployment rate expected to remain above 12 percent for the next year, should hold inflation to around 1 percent in 1997 and only slightly higher in 1998.

Executive Board Assessment

Executive Directors welcomed the authorities' fiscal consolidation efforts and the maintenance of a prudent monetary policy, which kept France firmly on the road to European Economic and Monetary Union (EMU). Directors observed that, under the impetus of rapid export growth, economic activity had strengthened somewhat over the past year, while inflation remained wholly under control. They thought that conditions were favorable for the recovery to broaden progressively in 1998, with GDP growth reaching close to 3 percent. Directors urged the authorities to seize the opportunity of the nascent upswing to strengthen fiscal consolidation. To ensure the sustainability of medium-term adjustment, Directors emphasized the need for even greater focus on reducing government spending. They also urged the authorities to decisively address deep-rooted structural problems in the economy, particularly those behind the high unemployment rate. This would require, in the view of Directors, imparting a more reformist momentum to policies concerning the labor market and social entitlements. Against that background, Directors welcomed the intergenerational accounts prepared by the staff on the interactions between demographic trends, fiscal policy, and output. It was suggested that the results of that analysis be conveyed to the French public to help build public support for longer-term adjustment efforts.

Monetary policy, Directors observed, had established very high credibility through a firm orientation to low inflation, the exchange rate link with the deutsche mark, and the timely achievement of EMU: this had eliminated interest rate differentials with Germany. As regards the decision to raise the money market intervention rate in early October, while some Directors considered it arguable whether there was a domestic case for raising rates at this point—with inflationary pressures absent and the recovery just broadening—most Directors observed that this measure was expected to have limited effects on activity, given the strongly positive lagged impact of interest and exchange rate changes over the past two years. Directors also noted that the adjustment had the merit of signaling commitment to full convergence ahead of the launch of EMU.

Directors welcomed the efforts of the authorities in recent months to bring the government deficit in line with the Maastricht criterion. This had changed the outlook sharply for the better from the situation only a few months earlier. However, they generally agreed that more ambitious fiscal plans for 1998 would be desirable in light of the favorable economic outlook, the importance of creating margins of maneuver for fiscal policy under EMU within the constraints of the Stability and Growth Pact, and the need to prepare now for the looming fiscal problems of an aging population. Accordingly, Directors urged the authorities to ensure that budgetary spending in 1997 and 1998 was held to no more than targeted levels and to start laying the groundwork now for early implementation of the expenditure and tax changes needed to reduce the government deficit on a sustainable basis.

As regards specific measures, Directors considered that action was needed to slim down government spending so as to achieve the needed fiscal consolidation while also allowing for a reduction in the heavy tax burden. Toward that end, they urged the authorities to move forward with reforms of the health care and pension systems and to strengthen the targeting of social transfers in line with the first steps recently taken in the area of family allowances. Planned measures to contain health care costs should be pressed through firmly and, if necessary, strengthened. A new round of pension reforms was called for, focused on encouraging a longer working life. On tax reform, much more could and should be done to reduce marginal rates, while further eliminating deductions and exemptions catering to special interests. Directors welcomed the recent decision to substitute the social tax, *contribution sociale généralisée*, for some payroll taxes, which will narrow the broad overall tax wedge that served as a disincentive for the hiring of low-skilled and long-term unemployed. At the same time, however, several Directors regretted the increase in the corporate tax surcharge, which could dampen employment creation and investment.

Directors emphasized that unemployment was, without question, the most deep-rooted problem facing France. True, wage moderation and encouragement for part-time work had rendered employment somewhat more responsive to growth; but unemployment had increased inexorably over the past decades—and was disturbingly severe among the young and low-skilled. While partly cyclical, unemployment was to a high degree structural in nature, largely reflecting the unwillingness of firms to hire those whose productivity did not warrant the minimum salary levels, and the limited incentives for some of the unemployed to seek training or employment.

Directors urged the authorities to reconsider the thrust of their labor market policies, benefiting from experience in other countries that had managed to cut unemployment durably while respecting core social concerns. Several Directors pointed to the OECD Jobs Study, which emphasized the benefits of less rigid government regulations in labor and product markets. A key need was to reduce the gap between labor costs and productivity, by upgrading skills and allowing significantly greater scope for the market to set wages, especially for the young and low-skilled. Directors also urged managing minimum social and unemployment benefits so as to favor insertion in the labor force, with clear and firm conditions on training and job search. While some Directors considered that new models of more flexible and reduced working time might offer a chance to increase employment, many other Directors expressed scepticism about the planned cut in the legal working week, which might raise structural unemployment rather than lower it. They saw risks that the low-skilled might suffer particularly since a rise in the hourly minimum wage would further price them out of the labor market, but the absence of such an increase could impair incentives vis-à-vis social benefit levels as well as lowering living standards. Moreover, the planned subsidies for employers were counter to fiscal priorities, and would introduce new distortions that might deter job creation. Directors urged the authorities to envisage a more flexible framework which allowed the negotiation of working conditions among the social partners at the firm and industry levels. Noting the authorities' intention to preserve the competitiveness of French businesses, they observed that reductions in working time not compensated by productivity gains should be accompanied by corresponding wage adjustments in order to prevent labor costs from soaring and employment from declining further.

In order for the economy to flourish under EMU, benefit from growing international integration, and create employment, Directors noted that it would be critical to strengthen product market competition and reinforce the discipline of market forces over management. Those considerations argued strongly for the continued privatization of publicly controlled enterprises, especially in the productive and financial sectors. In public services, efficiency could be promoted by ensuring that financial disciplines were set and respected, and competition encouraged. In this connection, efficient ownership structures, including privatization, should be considered.

Directors commended France for its development assistance, which remained at a level that was one of the highest among industrial countries.

Press Information Notices (PINs) are a new series of IMF press notices (see Press Release 97/21). PINs will be issued, at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies.

France: Selected Economic Indicators

	1993	1994	1995	1996	1997 1/
Real economy (change in percent)					
Real GNP	-1.3	2.8	2.1	1.5	2.3
Domestic demand	-2.2	3.0	1.8	0.9	1.3
CPI (year average)	2.1	1.7	1.8	2.0	1.1
Unemployment rate (in percent)	11.6	12.3	11.6	12.4	12.6
Gross national saving (percent of GDP)	18.2	19.0	19.8	18.8	19.3
Gross national investment (percent of GDP)	18.5	18.0	17.9	17.5	17.2
Public finance (percent of GNP)					
Central government balance	-4.2	-4.6	-4.0	-3.5	-2.8
General government balance	-5.6	-5.6	-5.0	-4.1	-3.1
Public debt	45.2	48.1	52.2	55.4	57.7
Money and interest rates					
M3 (end of year, percent change) 2/	-3.0	1.5	4.4	-3.4	-0.5
Money market rate (in percent) 3/	8.4	5.8	6.6	3.8	3.3
Government bond yield (in percent) 3/	6.9	7.4	7.6	6.4	5.5
Balance of Payments (in percent of GNP)					
Trade balance (percent of GDP)	0.6	0.5	0.7	1.0	1.5
Current account (percent of GDP)	0.9	0.6	0.7	1.3	2.2
Official reserves (US$ billion) 4/ 5/	22.6	26.3	26.9	26.8	28.9
Exchange rates					
Exchange rate regime			Member of ERM		
Present rate (October 24, 1997)			F5.97 per US$1		
Nominal effective exchange rate (1990 = 100) 5/	103.6	104.5	108.2	108.3	104.4
Real effective exchange rate (1990 = 100) 5/ 6/	99.0	98.1	98.0	95.3	91.0

1/ Staff projections, unless otherwise noted.
2/ July 1997.
3/ September 1997.
4/ Excluding gold.
5/ Average of the first eight months of 1997.
6/ Based on relative normalized unit labor costs in manufacturing.